

Covenants Not to Compete
by John J Camozzi¹

AB601 (Leach) was drafted and actively sponsored by the Partnerships and Limited Liability Companies Committee to conform the statutory exceptions to the general prohibition against covenants not to compete in Business and Professions Code sections 16601, 16602, and 16602.5.

Covenants not to compete have been enforceable against corporations and their shareholders in both equity transactions (stock sales) and asset transactions (sales of substantially all of its assets and related goodwill), but have only been enforceable against partnerships or limited liability companies, and their partners or members, in equity transactions (dissolution or dissociation).

This distinction has resulted in practical problems when structuring M&A transactions where the targets are the assets and related goodwill of a partnership or limited liability company.

AB601 eliminates the application of different statutory rules based upon the form of the target entity by generically extending the rule of Section 16601 to all “business entities”, defined as partnerships, limited liability companies, or corporations.

AB601 also seeks to conform the statutorily limited geographic scope of an enforceable restrictive covenant with the practical realities of modern commerce.

Current statutory law limits the enforceable geographic scope to the “specified county or counties, city or cities, or a part thereof” in which the seller business and transferred goodwill were conducted. The courts have recognized the impractical nature of these narrowly defined geographic boundaries and have typically focused on the actual geographic scope of the transferred goodwill. [*Fleming v Ray-Suzuki, Inc.* (1990) 225 Cal.App.3d 574] Nevertheless, transaction counsels have continued to draft sometimes elaborate savings clauses to conform the territorial reach of the restrictive covenant to the narrow statutorily permissible geographic boundaries.

AB601 eliminates the statutory requirement that the geographic scope of an enforceable restrictive covenant be defined by cities or counties. The enforceable geographic scope is now more generically defined as the “specified geographic area” in which the business and transferred goodwill are conducted.

AB601 was approved by the Governor on July 13, 2002, and will become law effective January 1, 2003. A copy of the bill and its complete legislative history may be found on the California Legislative Counsel’s website (www.leginfo.ca.gov).

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